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No. 678

In the Supreme Court of the United States

OCTOBER TERM, 1960

STATE-ADAMS CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Appeals (Pet. 39-47) is reported at 283 F. 2d 395.

JURISDICTION

The judgment of the Court of Appeals was entered on October 31, 1960. (Pet. 48.) The petition for a writ of certiorari was filed on January 27, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the taxpayer corporation, having been created in order to gain advantages for its shareholders under the law of the state of incorporation, having engaged in numerous business functions, and having held itself out as a corporation to third parties including the Commissioner, may later assert that for federal income tax purposes it was in fact unreal and a sham, and thus not taxable on its income.

STATUTES INVOLVED

Internal Revenue Code of 1939:

> SEC. 13 [as amended by Sec. 121 of the Revenue Act of 1950, c. 994, 64 Stat. 906]. NORMAL TAX ON CORPORATIONS.
>
> * * * *
>
> (b) [as amended by Sec. 121 (a) of the Revenue Act of 1951, c. 521, 65 Stat. 452] *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation * * * [a tax].
>
> * * * *
>
> (26 U.S.C. 1952 ed., Sec. 13.)
>
> SEC. 15 [as amended by Sec. 121 (f) of the Revenue Act of 1951, *supra*]. SURTAX ON CORPORATIONS.
>
> * * * *
>
> (b) *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year upon

the corporation surtax net income of every corporation * * * a surtax * * *.

* * * *

(26 U.S.C. 1952 ed., Sec. 15.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 52. CORPORATION RETURNS.

(a) *Requirement.*—Every corporation subject to taxation under this chapter shall make a return * * *.

* * * *

(26 U.S.C. 1952 ed., Sec. 52.)

STATEMENT

Edwin B. Sheldon and his sister, Frances Sheldon Whitehouse, were the trustees and life income beneficiaries of a testamentary trust, the assets of which included a building at the corner of State and Adams

Streets, Chicago, Illinois. Under date of May 1, 1915, they leased this property to a department store known as The Fair. It was a net lease under which The Fair was to undertake all the usual duties of ownership and management for the term of seventy-nine years, and to pay annual rentals ranging from $125,000 in the early years to $140,000 in the later years. The lease has never been modified. (Pet. 18-19.)

Upon the death of Edwin B. Sheldon, Frances Sheldon Whitehouse became the sole trustee. Upon her death, the trust was to terminate and its assets, including the State-Adams property together with The Fair lease, were to be distributed in fee to her six children, two of whom were nonresident aliens. By 1933, Frances Sheldon Whitehouse had become concerned about the devolution of ownership of the property upon her death because the Illinois laws then prohibited ownership of Illinois real estate by aliens for a period longer than six years, and because, if any of her children died, his proportionate share of the ownership would vest in beneficiaries who were minors. (Pet. 20-21.)

A plan was devised to convey title to the State-Adams property and The Fair lease to an Illinois corporation in exchange for its securities. The taxpayer here was created for that purpose, and Frances Sheldon Whitehouse delivered the deed to it in return for all its stock. She also assigned the lease to the corporation in return for its promissory note payable to her as trustee. The rate of interest on the note was to be equivalent to the amount of rent received

from The Fair. No cash was paid in to the corporation. (Pet. 23-24.)

At the organizational meeting of the corporation, directors and officers were elected and by-laws adopted. The Bank of Montreal was selected as the Illinois statutory office, and by resolution the corporation directed The Fair to deliver the rental checks to the bank in Chicago. After deducting its commission, the bank credited these payments to Frances Sheldon Whitehouse. (Pet. 24-25.)

A new note was issued by the corporation in April 1940. (Pet. 26.)

Frances Sheldon Whitehouse died on March 7, 1944, and the trust terminated. (Pet. 26.) Pursuant to a meeting of the corporation's directors, its shares were issued to Mrs. Whitehouse's children and grandchildren. The note she held was surrendered for cancellation, and new notes were issued to the shareholders. Pursuant to a corporate resolution, the Bank of Montreal was directed to continue to receive the rentals and credit them to the personal accounts of the noteholders. (Pet. 27-28.)

On January 28, 1947, the stockholders of the corporation held a meeting for the purpose of ratifying The Fair lease. (Pet. 30.) The interest rate of the corporation's notes was occasionally changed to coincide with the amount of rentals received by the corporation. The last such adjustment was effected at a special meeting of the board of directors held on April 12, 1954. (Pet. 30-31.) In all, there have been two stockholders' meetings and ten directors' meetings. (Pet. 33.)

The taxpayer's expenses consisted of Illinois franchise taxes, service fees charged by the bank, and legal fees deducted on the corporation's records in some years as compensation of officer or officers. (Pet. 31-32.)

The taxpayer filed income tax returns each year from 1933, reporting its rental income and deducting all of it, minus other expenses, as interest expense. (Pet. 34.)

The Commissioner asserted a deficiency in the taxpayer's income and excess profits taxes for the year 1951 on the ground that The Fair lease represented a contribution to the taxpayer's capital and not a loan, and that the taxpayer's alleged interest payments to its shareholders were in reality nondeductible dividends. In the Tax Court, the taxpayer did not contravene this determination, but took the position that it was "a mere conduit or agency formed and utilized for the sole purpose of holding title to real estate and therefore is not to be regarded as a separate taxable entity distinct from its stockholders." (Pet. 16.) The Tax Court so held. (Pet. 38.) The court below reversed, holding that the taxpayer was not a sham corporation and that the Commissioner was justified in recognizing its existence for federal income tax purposes. (Pet. 39-47.)

ARGUMENT

1. The Court of Appeals correctly held (Pet. 43-44) that the taxpayer, "having full beneficial ownership of the land and collecting the rent therefrom, engaged in business under the principles" stated in

Moline Properties v. *Commissioner*, 319 U.S. 436, and *National Investors Corp.* v. *Hoey*, 144 F. 2d 466 (C.A. 2d), and that it was not a sham corporation which must be ignored for tax purposes. The court pointed out (Pet. 40-43) that the corporation issued stock and notes in exchange for the property involved here; that it later cancelled these securities and issued new shares and notes, and several times modified their provisions; that it became the lessor, by assignment, of income-producing property (a department store) under an outstanding long-term lease of the property; that checks for the rent payable to the corporation were, at the direction of its officers and directors, delivered to a bank, which, also at the corporation's direction, deducted various corporate expenses, such as legal fees, bank fees, taxes, etc., and remitted the balance to the taxpayer's stockholders as so-called interest on the corporation's notes; that at least two stockholders' meetings, one of which was for the purpose of ratifying the lease, and at least ten directors' meetings, were held; that, after the corporation was dissolved for nonpayment of franchise taxes, the delinquent taxes were paid and the dissolution order vacated at the instance of its directors; that corporate income tax returns (required by Section 52(a) of the Internal Revenue Code of 1939, *supra*, p. 3) were filed in each year since the corporation was organized, in which its principal "business" was represented to be "real estate holding"; and that the corporation instituted and carried on in its own name this very litigation contesting the tax deficiency asserted by the Commissioner. These activities were clearly "the equivalent of business

activity" as described in the *Moline* case (*supra*, 319 U.S. at 438), and they fully support the holding of the court below that the corporation was not a mere sham.

The corporation was not any less a real corporation for federal income tax purposes than for state law and other ends. Indeed, the main objective of its creation, and of its acquisition of the rental property and lessor's interest, was to obviate anticipated difficulties under the Illinois law in connection with the devolution of title to the property—a purpose which was accomplished. Having served legitimate nontax purposes, and having held itself out to the state and to third parties such as the lessee, the bank, attorneys, etc., as a real corporation, the taxpayer was properly precluded from disavowing its reality for federal tax purposes. *Moline Properties* v. *Commissioner*, *supra*; *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422; *New Colonial Co.* v. *Helvering*, 292 U.S. 435; *Burnet* v. *Commonwealth Imp. Co.*, 287 U.S. 415; *Higgins* v. *Smith*, 308 U.S. 473.

2. The taxpayer mistakenly asserts a conflict between the decision below and *United States* v. *Brager Building & Land Corp.*, 124 F. 2d 349 (C.A. 4th). As the court below noted (Pet. 45), the *Brager* case involved a corporation which, unlike the taxpayer here, was the titular rather than the beneficial owner of property, and the court there applied the same settled principles which the court below applied here, but to a materially different set of facts.

Contrary to the taxpayer's assumption (Pet. 10-12), the court below did not hold that the existence of a corporation may never be disregarded for tax

purposes at the instance of the corporation. By way of dictum the court below did observe (Pet. 46) that the Commissioner has "greater freedom" to disregard the corporate entity for tax purposes than the parties who created it, an observation in accord with the decisions of this and other courts. *Higgins* v. *Smith*, *supra*, 308 U.S. at 477; *National Carbide Corp.* v. *Commissioner*, *supra*, 336 U.S. at 437, fn. 20; *Maletis* v. *United States*, 200 F. 2d 97 (C.A. 9th), certiorari denied, 345 U.S. 924; *Phillips* v. *United States*, 193 F. 2d 132 (C.A. 5th); *Commissioner* v. *Culbertson*, 337 U.S. 733, 753 (Frankfurter, J., concurring). Indeed, in *Paymer* v. *Commissioner*, 150 F. 2d 334 (C.A. 2d), on facts analogous to those of *Brager*, the court below permitted a corporation to disclaim its existence for tax purposes. However, it properly distinguished both *Paymer* and *Brager* from the instant case on the ground (Pet. 44-45) that in those cases the corporations were mere nominees, whereas in the present case the taxpayer was the true owner of property and as such engaged in business activities.

3. The taxpayer's contention (Pet. 12-14) that the decision below results in "confiscatory taxation" reduces itself to the anomalous proposition that the taxpayer should be relieved of income tax liability because, instead of first paying the corporate tax, it distributed its entire net income, including the amount of tax payable to the government, to its stockholder-noteholders. That the stockholders received more income than they would have received had taxpayer first satisfied its tax liability, and accordingly paid more individual taxes, manifestly furnishes no reason

to dispense with or reduce the corporate tax. Moreover, the situation of which taxpayer complains is of its own making, and results from its attempt to disguise what were in reality nondeductible dividend distributions to the stockholder-noteholders as deductible "interest". The Commissioner determined that the distributions represented nondeductible dividends within the scope of Section 22(a) of the Internal Revenue Code of 1939, *supra*, p. 3, and taxpayer conceded the correctness of that determination in both courts below (Pet. 34-35, 40) choosing to resist the tax imposed under Sections 13(b) and 15(b) of the 1939 Code, *supra*, pp. 2-3, on the theory that its corporate existence should be disregarded. Having failed to raise this alternative issue below, taxpayer may not now do so indirectly in this Court under the claim of "confiscatory taxation".

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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